

**CONTRACTING OUT:
POTENTIAL FOR
REDUCING FEDERAL
COSTS**

The Congress of the United States
Congressional Budget Office





NOTES

Unless otherwise indicated, all years referred to in this report are fiscal years.

Details in the text and tables of this report may not add to totals because of rounding.

PREFACE

In its Circular A-76, the Office of Management and Budget directs agencies to procure support services from private firms. The practice has strong proponents and detractors. The Administration would like to see the use of private firms expanded, believing it provides a way of reducing federal costs without cuts in service levels.

This study, undertaken at the request of Senator Humphrey, former chairman of the Senate Armed Services Subcommittee on Preparedness, provides background on the A-76 program and the questions surrounding it. It also estimates the cost reductions possible under the current program and several alternative approaches. The report updates the Congressional Budget Office's (CBO's) 1982 report on the same subject, incorporating knowledge gained from the significant federal experience with A-76 that has accumulated since that time. In keeping with CBO's mandate, no recommendations are made.

R. Mark Musell of the General Government Management staff of CBO's Office of Intergovernmental Relations prepared the paper under the supervision of Stanley L. Greigg and Earl Armbrust. The author gratefully acknowledges the contribution of Daniel W. Coffey, who provided data processing support. Many individuals provided advice, information, and comments, and the author would especially like to acknowledge the assistance of staff members at the Department of Defense and the Office of Management and Budget. Paul L. Houts edited the manuscript. Mary V. Braxton typed the many drafts and prepared the report for publication.

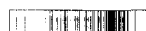
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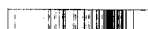
SUMMARY

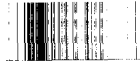
The government can often reduce costs by obtaining data processing, maintenance, and other commercial-type support services from private firms under contract instead of doing the work in-house using federal employees. The practice of contracting out, however, is controversial. Advocates point to the potential savings, noting also that private markets are strengthened when the government refrains from performing commercial activities itself. Opponents focus on the lower quality of services that contractors may provide and on the loss of federal jobs. Others question just how much contracting out actually reduces federal costs. Some managers complain that contracting out limits their control and makes establishing accountability difficult.

Over the last three years, contracts awarded for commercial-type services have increased by about 10 percent--from \$32.8 billion in 1983 to \$36.0 billion in 1985 (measured in 1983 dollars). Considerable room remains, however, for expansion. For example, Department of Defense (DoD) inventory data for 1985 show the equivalent of about 105,000 full-time civilian jobs in activities that could eventually be considered for contracting out. Federal regulations and provisions of certain statutes exempt another 275,000 jobs from private-sector operation. Although agency inventories do not yet cover all of the commercial activity in government, even under current levels of effort, activities already in inventories could keep agency contracting out programs busy for many years.

CURRENT POLICY AND THE ADMINISTRATION'S STANCE

In view of recent budgetary constraints, interest in the savings potential of contracting out has grown. The present administration has promoted it as a method of lowering federal costs without cutting services. Executive Branch policy, detailed in Office of Management and Budget (OMB) Circular A-76, stipulates that agencies must rely on the private sector for commercial-type services unless the government can provide them more economically. As such, guidelines that accompany Circular A-76 set down procedures for agencies to use in making comparisons of in-house and contract costs.





When agencies enter an in-house activity for cost comparison, its cost must reflect the most efficient and effective federal operation, as identified in management reviews. To win a contract, therefore, a private firm must beat the best price at which the government can provide a service. When the government wins a cost competition, agencies are expected to make improvements identified in management reviews. Under these procedures, the government can realize savings under A-76 even when activities remain in-house.

POTENTIAL COST REDUCTIONS UNDER THE CURRENT PROGRAM

Analysis by the Congressional Budget Office (CBO) shows that management improvements and contracting out under A-76 can substantially reduce federal costs. Savings in the near term, however, may be smaller than the total savings available since certain cash reductions for items, such as retirement, do not occur for many years. CBO, therefore, prepared two sets of estimates: one representing near-term cash savings; another measuring savings on an accrual basis. Under accrual accounting, costs are assigned to the period in which they are incurred, regardless of when cash disbursements actually take place. Thus, accrual estimates provide a measure of the total potential savings to the government, even though part of that savings may not take the form of lower cash disbursement for many years. Resources freed up as a result of A-76 activity could be applied to meet other program requirements or to reduce the budget deficit.

Uncertainties about the extent and outcome of A-76 activity in the future limits the accuracy of estimates concerning the program's impact. The CBO approach, which focuses exclusively on ongoing activities subjected to cost comparisons, relies heavily on DoD's record of experience with A-76, which is the most extensive and well documented among federal agencies. Based on its analysis of DoD and other data, CBO estimates assume that, over the next five years, agencies will perform A-76 reviews for activities covering the equivalent of 10,000 full-time workers annually. Of these, 65 percent will be contracted out, with savings averaging 35 percent of in-house costs. For activities remaining in-house, CBO estimates assume that management improvements would reduce costs, on average, by 20 percent.

Reductions in Costs on an Accrual Basis

Should current levels of effort continue, CBO estimates that management improvements and contracting out together could free up about 7,200

federal jobs per year and, on an accrual basis, reduce the cost of the activities reviewed each year by about 30 percent, or \$130 million (full-year impact in 1988 dollars). Savings at the Department of Defense would total some \$90 million, and about three-fifths of this amount could result from freeing resources associated with uniformed military personnel DoD sometimes uses in commercial activities. Contracting out alone would account for about 6,500 of the jobs freed up annually. These conversions would drop the cost of activities shifted by an average of 35 percent, or \$100 million. For those activities remaining in-house, management improvements would free up 700 jobs annually, reducing costs by \$30 million, or 20 percent.

Reductions in Costs on a Cash Basis

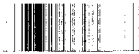
In the near term, a year's worth of effort under the A-76 program could generate cash savings of \$70 million--compared with accrual cost savings of \$130 million (full-year impacts in 1988 dollars). Over the five-year period from 1988 through 1992, some 36,000 jobs could be trimmed from the federal work force and cumulative cash savings could average about \$200 million--\$135 million from contracting out and \$65 million from management improvements. Over that same period, cumulative cash savings at DoD could average \$140 million. (These five-year estimates consider the effects of price changes and assume A-76 reviews occur evenly throughout the year. In addition, the savings from each year's A-76 activity are considered to continue through all five years covered by the estimates.)

OPTIONS FOR THE A-76 PROGRAM

The Congress may choose to take any one of a number of actions on the A-76 program--most would either increase contracting out or restrict it. The Congress also has several choices for carrying out any changes. For example, it may pass specific authorizing legislation or provide direction to agencies during the course of oversight and appropriation hearings.

As previously mentioned, proponents view commercial activity as beyond the proper purview of government and point to the savings available from private sector operation. Those who support more contracting out voice many of these same arguments. In the same way, advocates of less contracting out point to the concerns raised by critics of A-76--the loss of federal jobs, the cost increases that sometimes follow contracting out, the loss of quality, and the fairness of cost comparison procedures. Options I and II below describe different approaches to expanding contracting out.





Option III would restrict it. The various options described each offer the opportunity to reduce federal costs (see Summary Table). Of course, the Congress could always choose to make no changes and still achieve cash savings averaging about \$200 million over five years.

Option I: Increase A-76 Reviews

The Congress could choose to expand contracting out by increasing the number of A-76 reviews that agencies performed annually. A number of options could be adopted to increase reviews. The Congress could, for

SUMMARY TABLE. AVERAGE ANNUAL COST AND JOB REDUCTIONS
FROM OPTIONS FOR THE A-76 PROGRAM,
1988-1992

	Job Reductions	Reduction In Cash Costs (In millions of dollars)	Reduction In Accrual Costs (In millions of 1988 dollars)
The Current Program	7,200	200	325
Option I	14,400	400	650
Option II	20,000	140	305
Option III	4,000	370	430

SOURCE: Congressional Budget Office.

NOTE: Dollar amounts rounded to the nearest \$5 million. Estimates represent the full effects of each option rather than changes from the current program. Both the cash and accrual estimates assume A-76 reviews occur evenly throughout a year and that savings from each year's reviews continue through the end of the five-year estimating period. In addition, cash savings have been adjusted to reflect price changes.

example, reduce legislative restrictions on contracting out. Because of such restrictions, agencies with large commercial work forces--such as the Veterans Administration--do few A-76 reviews. The Congress could also consider legislation requiring agencies to perform reviews according to a specific, accelerated schedule. Certain measures to reduce opposition to contracting out by federal employees might also increase A-76 activity. For example, a placement program for workers adversely affected by A-76 might reduce some of the more severe hardships on employees and, therefore, somewhat diminish employee resistance to A-76.

While it is not clear precisely by how much A-76 reviews would increase in response to these or other measures, it is not unreasonable to assume that activity could double--covering the equivalent of about 20,000 federal workers. Similarly, job reductions and savings could double.

Option II: Shift Activities Without Comparisons

Another approach to expanding contracting out would be to require the Executive Branch to abandon cost comparisons and shift activity to private firms regardless of particular cost impacts. Such an approach would be consistent with original federal policy, which stressed getting the government out of the business of providing commercial services. Without lengthy cost comparison procedures, agencies could contract out a greater number of activities, though the government would not realize savings in every case. If activities covering 20,000 jobs were shifted annually, reductions in cumulative cash costs would average \$140 million through 1992. Reductions in accrual costs over five years would average \$305 million annually. The cost increases that contracting out would cause for some programs might compound difficulties brought about by general measures to reduce federal spending. Moreover, without competitions that pit in-house against contract operations, private firms in some areas may have little incentive under this option to offer the government their best price.

Option III: Suspend Contracting Out

Taking an opposite approach, the Congress could suspend contracting out. Such a suspension might be permanent, which would recognize the continuing controversy surrounding the A-76 program, or it might be temporary, which would provide an opportunity for full consideration of specific reforms. This option assumes a five-year suspension of contracting out and a corresponding increase in management reviews to a level covering about 20,000 jobs annually. If agencies continued to find savings averaging





20 percent from management improvements, about 4,000 federal jobs would be freed up annually. Cumulative reductions in cash costs would average \$370 million through 1992. Reduction in accrual costs would average \$430 million per year. Without the threat of contracting out, however, the Congress would have to take action to ensure that agencies continued to find management improvements. It could, for example, reduce agency budget requests to reflect expected savings from improved management.

CHAPTER I

INTRODUCTION

Instead of performing commercial services in-house using federal workers, the federal government can often reduce its costs by contracting with a private-sector firm. In fact, Executive Branch policy set forth in the Office of Management and Budget's (OMB) Circular A-76 requires agencies, with some major exceptions, to use contractors for commercial services if such an approach is less expensive.^{1/} Even so, in many agencies commercial activity is quite extensive. According to agency data, government commercial activity at the Department of Defense (DoD) alone encompasses about 380,000 federal jobs. These jobs support activity like food preparation, maintenance, warehousing, and data processing.

Contracting out for federal services has been a source of continuous and often heated controversy for the 30 years it has been federal policy. The Congress has shown its interest by making numerous legislative proposals on the subject. Some of the proposals would increase contracting out; others would reduce it. Because of current budgetary constraints, however, recent attention has focused on the potential savings from contracting out. In its recent budget reports citing potential cost reductions, OMB included a description of its efforts to increase Executive Branch contracting out.^{2/} Given the current interest in the savings potential of contracting out, this Congressional Budget Office (CBO) study:

- o Reviews commercial-type activity in government and the A-76 program;
- o Describes the potential for reducing near- and long-term costs by contracting out under current policies and practices; and

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1. Office of Management and Budget, *Circular No. A-76* (Revised), August 4, 1983. Implicit authority for Circular A-76 derives from 31 United States Code (USC) Section 1111 and other authority, which permits the government to undertake actions necessary to improve the economy and efficiency of its operations.
 2. Office of Management and Budget, *Management of the United States Government* (1987), pp. 71-75; *Budget of the United States Government* (1988), p. m-9.



- o Sets forth policy options for contracting out and their potential to reduce costs.

The reader should guard against confusing the contracting out program described in this report with other Administration efforts to increase reliance on the private sector, including those efforts designed to sell federal business-type operations. The term "privatization" is often applied to all such efforts, though they differ greatly in their approach to enlisting private-sector support, in potential budgetary implications, and in the concerns they raise about policy and implementation.

THE A-76 PROGRAM: HOW DECISIONS ARE MADE

Contracting out to curb costs is a common practice at all levels of the public sector. Private firms can offer services at lower costs for a variety of reasons: competition from other firms that encourages efficient operations, freedom from bureaucratic procedures, and flexibility to control their compensation costs and employment levels. Recent administrations, representing both political parties, have issued regulations to federal agencies that encourage the use of contracting out. The current federal program evolved from a policy, first formally promulgated in 1955, that stressed relying on the private sector for certain goods and services. As currently set forth, federal policy emphasizes relative costs, stipulating that federal agencies may not start or continue commercial services in-house when private firms can do the work for less. Moreover, revisions of federal policy in 1983 increased the emphasis on improving the management of commercial services. To this end, Circular A-76 and supplements to it establish requirements for monitoring the quality of services according to specific measures of output and timing, and for conducting management reviews to identify possible improvements in the in-house operation of services.

The A-76 program distinguishes commercial activities from inherently governmental functions to which it does not apply. A commercial activity, as defined under Circular A-76, is one providing goods or services an agency could obtain from a private source. Governmental functions, as defined by the circular, are those so "intimately related to the public interest that they mandate the use of federal employees." These functions include activities requiring the exercise of discretion in applying governmental authority or the use of value judgments in making decisions. Among the specific governmental functions identified in the circular are criminal investigation, program management, regulation of industry and commerce, control of Treasury accounts, and tax collection.

Cost Comparisons

To determine the most economical approach, A-76 requires agencies to compare the costs of providing a commercial service in-house with those of contracting it out. Agencies must prepare comparisons for their existing in-house commercial activities or when planning to expand an activity or to shift an activity back to in-house operation. A cost comparison handbook that supplements Circular A-76 prescribes the costs to be included when making comparisons and the methods for estimating them. 3/

When agencies estimate in-house costs for comparisons, they use the total cost of employee compensation, including the costs of retirement (computed on an accrual basis) and other fringe benefits. CBO's analysis shows that personnel costs represent, by far, the largest percentage of the total costs of in-house performance. According to a review of 1985 DoD cost comparisons, direct personnel costs made up nearly three-fourths of the costs estimated for performing activities in-house. Other in-house costs covered by cost comparison guidelines include direct overhead, material, and equipment. All in-house costs included in comparisons must assume that certain cost cutting measures will be carried out. (These measures are identified in management improvement studies required by A-76 and described in the next section.)

Under A-76 guidelines, contractor costs largely reflect the price of the best bid received from private firms. These bids are influenced by Department of Labor regulations that set minimum wages for workers under service contracts with the federal government on the basis of prevailing local compensation practices. 4/ To factor in certain costs that arise when the government converts work to service contracts, the cost comparison guidelines require that agencies make several upward adjustments to the contractor's price. These include federal expenses for contract administration and the cost of any severance pay should workers be laid off. The

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3. The description of the cost comparison process presented in this section draws on information from the most recent cost comparison handbook. Because the bulk of cost comparisons that agencies prepare cover ongoing in-house work, procedures employed for such activities serve as the focus of the text's discussion. The cost comparison handbook sets out additional calculations, not described in the text, for expansions and conversions back to in-house performance.
 4. Minimum wages for service contracts entered into by the federal government are set by the Secretary of Labor under authority of the Service Contract Act of 1965, 41 USC Section 351 and sections following.

